LIBRARY
SUPREME COURT, U. S.

No. 71-1006

MAR 22 1972
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1971

VIRGINIA NATIONAL BANK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

ERWIN N. GRISWOLD,
Solicitor General,

SCOTT P. CRAMPTON
Assistant Attorney General,

THOMAS L. STAPLETON,
DAVID ENGLISH CARMACK,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-1006

VIRGINIA NATIONAL BANK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the district court (Pet. App. 19-27) is reported at 321 F. Supp. 316. The opinion of the court of appeals (Pet. App. 29-35) is reported at 450 F. 2d 1155.

JURISDICTION

The judgment of the court of appeals was entered on November 15, 1971 (Pet. App. 36). A petition for rehearing was denied on December 15, 1971 (Pet. App. 37). The petition for a writ of certiorari was filed on

February 7, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether payments that Virginia law requires petitioner to make to some of its shareholders are nondeductible dividends or are deductible either as ordinary and necessary business expenses under Section 162, or as taxes under Section 164(a) or (c), of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162, 164 and 316 of the Internal Revenue Code of 1954, Sections 1.164-7 and 1.301-1 of the Treasury Regulations on Income Tax (1954 Code), and Chapter 10 of Title 58 of the Code of Virginia of 1950, as amended, are set forth in the Appendix to the petition (Pet. App. pp. 38-61). The pertinent provisions of Sections 301 and 312 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

Petitioner is a national bank doing business in Virginia. Under authority of Revised Statutes, Section 5219, as amended (12 U.S.C. 548), permitting states to levy taxes upon the shares of national banking associations within their limits, Virginia imposes an annual tax (§§ 58-465, *et seq.*, c. 10, Code of Va., 1950, Ann.) upon the stock of national bank shareholders at the rate of one dollar on each one hundred dollars of the stock's value. Some of petitioner's shareholders—

charities and insurance companies—are exempt from the tax. Virginia law (§ 58-480.1, c. 10, Code of Virginia, 1950, Ann.) requires that the banks pay directly to such exempt shareholders an amount equal to the tax that would be assessed against them if they were not exempt.[1] (Pet. App. 20-22, 29-30.)

In accordance with state law, petitioner paid the Virginia tax with respect to those of its shareholders that were subject to it, and also made the payments required by Virginia law to shareholders that were exempt from the tax. During the taxable years in suit (1963-1966), the former payments amounted to more than $1.1 million, and the latter to approximately $36,500. Petitioner did not formally declare a dividend to cover either type of payment. (Pet. App. 22-23.)

On its federal income tax returns for the taxable years, petitioner deducted all of the payments required by state law—both the taxes paid to Virginia and the distributions to tax-exempt shareholders. The Commissioner allowed deductions for the former under Section 164(e) of the Internal Revenue Code of 1954, which permits a corporation to deduct taxes paid by it on behalf of shareholders whose stock interest in a corporation is subject to tax, and further provides that under such circumstances the shareholders shall not be entitled to deductions. He disallowed deductions for

---

[1] Prior to 1964, such payments could be turned over to the State, which would then distribute them to the tax-exempt shareholders. A 1964 amendment to the state law did away with the initial transfer to the State, and provided that each national bank make direct payments to those of its shareholders exempt from the state tax. (Pet. App. 22.)

the payments to tax-exempt shareholders on the ground that they were nondeductible corporate distributions to shareholders. Petitioner paid the taxes in dispute, and thereafter brought this suit for refund, claiming that the payments to tax-exempt shareholders were deductible either as taxes under Section 164(a) or (e) or as ordinary and necessary business expenses under Section 162. (Pet. App. 22-23, 30.)

The district court concluded that because the payments to tax-exempt shareholders were made annually and under compulsion of Virginia law, they qualified as ordinary and necessary business expenses under Section 162 (Pet. App. 23-24). It alternatively held them deductible as taxes (Pet. App. 24-27). A divided Fourth Circuit reversed, holding that the payments were nondeductible corporate distributions, and that neither the state law requirements nor the annual nature of the payments made them deductible as ordinary and necessary business expenses or as taxes.[2] (Pet. App. 29-35.)

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review.

1. A distribution by a corporation to its shareholders as such is to be treated as a dividend to the extent of the corporation's post-1913 earnings and profits. Section 301(a) and (c), Appendix, *infra*, pp. 9-10, and Section 316 of the Internal Revenue Code of 1954;

[2] The dissenting judge agreed that the payments were not deductible as taxes, but concluded that ordinary and necessary business expense deductions were warranted (Pet. App. 35).

Treasury Regulations on Income Tax (1954 Code), § 1.301-1(c). Such a distribution is not a cost of doing business,[3] and is not deductible under Section 312(a) of the Code, Appendix, *infra*, p. 10. The nondeductible character of a corporate distribution is not altered by the fact that there is no formal dividend declaration by the corporation,[4] that the distribution is only to certain shareholders,[5] is not intended,[6] or is compelled.[7]

Application of these fundamental rules to the facts of this case requires the conclusion that the payments in question constitute nondeductible corporate distributions within the meaning of the relevant statutory provisions. The payments indisputably were made to the exempt shareholders in their capacity as shareholders, and came from petitioner's earnings and profits. No more is necessary to the resolution of this case.

The court below thus was correct in rejecting petitioner's contention that the requirement of Virginia law that payments be made annually to exempt shareholders somehow converted their character from non-

---

[3] *Swed Distributing Co.* v. *Commissioner*, 323 F. 2d 480 (C.A. 5).

[4] *Sachs* v. *Commissioner*, 277 F. 2d 879, 882 (C.A. 8), certiorari denied, 364 U.S. 833; *Hash* v. *Commissioner*, 273 F. 2d 248, 250 (C.A. 4); *Paramount-Richards Theatres* v. *Commissioner*, 153 F. 2d 602, 604 (C.A. 5); *Nickerson Lumber Co.* v. *United States*, 214 F. Supp. 87, 92 (Mass.).

[5] *Sachs* v. *Commissioner*, *supra*, 277 F. 2d at 882; *Hash* v. *Commissioner*, *supra*, 273 F. 2d at 250; *Nickerson Lumber Co.* v. *United States*, *supra*, 214 F. Supp. at 92.

[6] *Sammons* v. *United States*, 433 F. 2d 728, 732 (C.A. 5); *Sachs* v. *Commissioner*, *supra*, 277 F. 2d at 883; *Hash* v. *Commissioner*, *supra*, 273 F. 2d at 250.

[7] *Swed Distributing Co.* v. *Commissioner*, *supra*, 323 F. 2d at 483.

deductible distributions of earnings and profits into ordinary and necessary business expenses. The payments are no less dividends because made regularly. A dividend is the "recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business." *Hellmich* v. *Hellman*, 276 U.S. 233, 237.

Nor does a corporate dividend become a deductible business expense merely because the distributing corporation is required to make it. Many distributions to shareholders are compelled—for example, required dividends on cumulative preferred stock, dividends deemed to have been declared under the foreign personal holding company provisions of the Code (Sections 551 *et seq.*), and dividends paid to avoid the accumulated earnings tax imposed by Section 531 or the personal holding company tax imposed by Section 541. But they are not any the less dividends for that reason. As this Court stressed only last Term in *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, 359, "the fact that a payment is imposed compulsorily upon a taxpayer does not in and of itself make that payment an ordinary and necessary [business] expense within the meaning of Section 162 (a) of the 1954 Code." See also *National Bank of Commerce* v. *Allen*, 223 Fed. 472, 477 (C.A. 8); *Swed Distributing Co.* v. *Commissioner*, 323 F. 2d 480 (C.A. 5).

2. The payments likewise are not deductible as taxes under Section 164(a) or (e). Section 164(a) provides for the deduction of taxes, but only by the taxpayers upon whom they are imposed. See Section 1.164-1(a)(5), Treasury Regulations on Income Tax (1954 Code)

(26 C.F.R.). Virginia law does not impose the tax on national banks but "upon each stockholder * * * of the shares of [such] stock" (other than exempt shareholders). Since no tax is imposed on petitioner, it may not take a deduction under Section 164(a).[8]

Accordingly, the only possible argument for a tax deduction rests on Section 164(e), which permits a corporation to deduct taxes paid by it on behalf of its shareholders upon whom a tax is imposed. But, as the court below recognized (Pet. App. 34), petitioner did not pay taxes for its tax-exempt shareholders. It merely distributed corporate earnings to them. Section 164(e), as its legislative history indicates (see S. Rep. No. 275, 67th Cong., 1st Sess., p. 19), is designed to permit a corporation to deduct taxes that otherwise would be deductible by shareholders. Since the tax-exempt shareholders were not taxed, and therefore were not entitled to a tax deduction, there is no deduction that could be transferred to petitioner under Section 164(e).

3. Petitioner devotes considerable argument (Pet.

---

[8] This is true not only for the payments to exempt shareholders, but also for the actual taxes paid to Virginia with respect to the shares of nonexempt shareholders. Deduction of the latter payments is allowed only under Section 164(e), which artificially permits the deduction of the payments as if the corporation had paid the taxes on its own behalf. See *Porter* v. *United States*, 27 F. 2d 882, 885 (C.A. 9); *First Nat. Bank of Jackson, Miss.* v. *McNeel*, 238 Fed. 559 (C.A. 5); *National Bank of Commerce* v. *Allen*, 223 Fed. 472 (C.A. 8); *Eliot Nat. Bank* v. *Gill*, 218 Fed. 600 (C.A. 1); Art. 566 of Treasury Regulations 45 (1920 ed.); T.D. 1763, 15 Treasury Decisions, Internal Revenue 25 (1912). See also I.T. 1300, I-1 Cum. Bull. 11 (1922); *Bank of Mount Hope* v. *Commissioner*, 25 B.T.A. 542. Compare Rev. Rul. 70-293, 1970-1 Cum. Bull. 282, 283.

11-15) to the question whether Virginia may compel national banks to make distributions. Whatever the answer may be to that question, it has no bearing on the tax issue presented here. The question of Virginia's power to compel distributions could properly be raised only in a case where a national bank or a shareholder challenged the Virginia statute. That is not this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

THOMAS L. STAPLETON,
DAVID ENGLISH CARMACK,
Attorneys.

MARCH 1972.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis.*—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis.*—

(A) *In general.*—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) *Distributions out of increase in value March 1, 1913.*—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value

accrued before March 1, 1913, shall be exempt from tax.

* * * * * *

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) *General Rule.*—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property, so distributed.

* * * * * *

☆ U.S. Government Printing Office: 1972—460-372/375